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In The

Supreme Court of the United States

October Term, 1997

CENTURY OFFSHORE MANAGEMENT CORPORATION,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Sixth Circuit

BRIEF OF THE JICARILLA APACHE TRIBE AS *AMICUS CURIAE* IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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INTEREST OF THE *AMICUS CURIAE*[1]

The Jicarilla Apache Tribe (the "Tribe") is an American Indian tribe recognized by the United States government and organized under Section 16 of the Indian Reorganization Act of 1934, 25 U.S.C. § 476 (1994). *See Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130 (1982). The Jicarilla Apache Reservation (the "Reservation") is located in the northwest quadrant of the state of New Mexico, on the eastern edge of the San Juan Basin, which is the second largest natural gas field in the lower 48 states. The exterior boundaries of the Reservation have been established by a series of executive orders.[2]

The land area within the exterior boundaries of the Reservation totals approximately 980,000 acres, virtually all of which is held in trust by the United States for the Tribe. The United States holds all minerals under 900,000 acres of the Reservation in trust for the Tribe. The Tribe is the lessor and royalty owner in approximately 136 oil and

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[1] Pursuant to Rule 37.6 of the Rules of this Court, the Jicarilla Apache Tribe states that no counsel for a party authored this brief in whole or in part, and that no person or entity other than the Jicarilla Apache Tribe and its counsel made any monetary contribution to the preparation or submission of this brief. Pursuant to Rule 37.2 of the Rules of this Court, the parties have consented to the filing of this *amicus* brief. The parties' letters of consent have been filed with the Clerk.

[2] *See* Exec. Order of February 11, 1887; Exec. Order of November 11, 1907; Exec. Order of January 28, 1908; Proclamation of the Secretary of the Interior dated September 1, 1988, 53 Fed. Reg. 37355 (1988); Proclamation of the Secretary of the Interior dated September 1, 1988, 53 Fed. Reg. 37356 (1988).

gas mining leases issued under the Indian Mineral Leasing Act of 1938, 25 U.S.C. § 396a to 396g (1994), for the production of oil and gas from Reservation trust lands. The terms of those leases are prescribed by the Secretary of the Interior. *See id.* § 396b (1994); 25 C.F.R. §§ 211.1 to 211.29 (1997). Those leases cover over 300,000 acres (approximately one-third) of the Reservation. The Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. §§ 1701-1757 (1994), charges the Secretary of the Interior with the responsibility of accounting for and collecting royalties and other payments due the Tribe from oil and gas production on its Reservation. The Tribe has entered into an agreement with the Minerals Management Service ("MMS") for joint audits of oil and gas leases on the Reservation.

The Tribe has a direct and substantial interest in the proper calculation and collection of royalties under its oil and gas leases. During the period from 1990 through 1996, oil and gas production on the Reservation accounted for over 80 percent of the Tribe's governmental operating revenues. Over half of the Tribe's income from oil and gas activity consists of production royalties which are subject to MMS valuation regulations; the balance consists of tribal taxes on oil and gas activity. The Tribe relies on revenue from oil and gas production to fund the provision of essential governmental services on the Reservation, including the police department, the tribal court, emergency ambulance services, community services, alcoholic rehabilitation, day care services, elderly care, and tribal regulation of oil and gas operations.

There are approximately 100 lessees and operators on the Reservation operating under the oil and gas leases

subject to MMS supervision. Three major gas pipeline companies provide gathering and transportation services to these lessees and operators. Many of the lessees and operators on the Reservation have entered into settlements with those pipeline companies concerning termination of long-term gas-purchase contracts, many of which contracts imposed take-or-pay liability on the pipeline companies. The Tribe has a direct economic interest in the extent to which those settlement payments give rise to royalty obligations.

ARGUMENT

I. THE INTERPRETATION OF FEDERAL MINING LEASES WILL AFFECT MINING LEASES OF INDIAN LANDS, WHICH CONTAIN ROYALTY CLAUSES SIMILAR TO THOSE CONTAINED IN THE FEDERAL LEASES

The royalty clause in the federal lease interpreted by the Sixth Circuit in this case is substantially similar to the royalty clause in the leases drafted by the Department of the Interior for oil and gas production on the Jicarilla Apache Reservation. The federal leases authorize the Department of the Interior (the "Department") to collect royalties on the "amount or value of production saved, removed or sold" from the leased premises. *See In re Century Offshore Management Corp.*, 111 F.3d 443, 445 (6th Cir. 1997) (citing Outer Continental Shelf Lands Act, 43 U.S.C. §§ 1331-56 (1996)). Similarly, the Indian leases authorize the Department to collect royalties on "the

value or amount of all oil, gas, and/or all other hydrocarbon substances produced and saved from" the leased land. *See Independent Petroleum Assoc. of America v. Babbitt*, 92 F.3d 1248, 1252 (D.C. Cir. 1996) (citing 43 U.S.C. § 1337(a)(1)(A); 30 U.S.C. § 226(b); 25 C.F.R. § 211.13 (1995); 25 C.F.R § 212.16 (1995)); *id.* at 1262 n.8 (Rogers, J., dissenting). Resolution of the question whether lump sum payments made to settle take-or-pay contracts are royalty bearing under the royalty clause of the federal-land leases will affect the Department of the Interior's assessment of royalties on such payments associated with leases of the Tribe's lands.

II. THE UNITED STATES HAS TRUST OBLIGATIONS TO INDIAN TRIBES; THESE TRUST OBLIGATIONS REQUIRE THE DEPARTMENT TO MAXIMIZE ROYALTIES ASSESSED ON INDIAN LANDS

The United States acts as a trustee to dependent Indian tribes. *See generally Seminole Nation v. United States*, 316 U.S. 286 (1942). When assessing royalties on oil and gas production from Indian lands, the Secretary of the Interior's actions are evaluated under a stringent, lessor-oriented standard that requires the Secretary to act according to his fiduciary obligations to the Indian lessor. *Jicarilla Apache Tribe v. Supron Energy Corp.*, 728 F.2d 1555, 1563 (10th Cir. 1984), *dissenting opinion of J. Seymour adopted as majority en banc opinion*, 782 F.2d 855 (10th Cir. 1986) (Because the Secretary of Interior is obligated to act as a fiduciary to the Indian lessor in administration of the Indian lessor's oil and gas reserves, "his actions must not merely meet the minimal requirements of administrative

law, but must also pass scrutiny under the more stringent standards demanded of a fiduciary."); *see also, e.g., Cheyenne-Arapaho Tribes of Oklahoma v. United States*, 966 F.2d 583, 589 (10th Cir. 1992); *Assiniboine and Sioux Tribes v. Board of Oil and Gas Conservation*, 792 F.2d 782, 794 & 794 n.15 (9th Cir. 1986). The Secretary's trust obligations to Indian royalty owners must be considered in evaluating the question whether take-or-pay settlement payments are royalty-bearing.

III. THE FIFTH, SIXTH, EIGHTH, AND DISTRICT OF COLUMBIA CIRCUITS HAVE REACHED INCONSISTENT RESULTS AND HAVE ADOPTED INCONSISTENT ANALYSES TO DECIDE WHETHER A SETTLEMENT PAYMENT MADE TO EXTINGUISH TAKE-OR-PAY LIABILITY IS ROYALTY BEARING

A. Explanation of Take-or-Pay Settlement Payments

The cases discussed below involve disputes over whether lump-sum payments made by gas pipeline companies to gas producers to settle large take-or-pay liabilities accrued under long-term gas-purchase contracts are properly subject to royalty. This issue arises from a fundamental change in the natural gas industry over the past decade. Many pipeline companies entered into long-term gas-purchase contracts with gas producers who were lessees of federal, Indian, state and private lands. Many of these contracts contained "take-or-pay" provisions, which required the pipeline company to pay for much of the contracted-for gas even if it did not take the gas. Often, the take-or-pay payments were "recoupable," meaning that the pipeline company could credit these payments toward "make-up gas" taken at a later date.

In the 1980's the Federal Regulatory Energy Commission began a major deregulation of wellhead prices of natural gas. After deregulation, the market price for gas dropped well below the long-term contract prices the pipeline companies were committed to pay. As a result, these long-term gas-purchase contracts, in particular the take-or-pay provisions, became extremely burdensome for the pipeline companies. Many of them settled the long-term gas-purchase contracts with the producers by making a lump-sum settlement payment to extinguish the pipeline company's obligations under these contracts, including the pipeline company's take-or-pay obligations.

The cardinal issue in the cases discussed below is whether those take-or-pay settlement payments are properly royalty bearing. As will become evident from the following discussion, the respective Circuit Courts of Appeals have diverged widely on this question, both in terms of the results reached and the analysis applied.

B. Survey of the Approaches Taken by the United States Courts of Appeals on the Question Whether Lump-Sum Payments Made to Extinguish Take-or-Pay Liability are Royalty Bearing

The first United States Court of Appeals case to address the issue of whether take-or-pay payments are royalty bearing was the Fifth Circuit in *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159 (5th Cir. 1988). *Diamond Shamrock* did not involve a settlement payment, but rather addressed the issue of whether take-or-pay payments during the life of a gas-purchase contract are royalty bearing. The royalty provision in the lease at

issue in *Diamond Shamrock* required the lessee-producer on federal lands to pay the federal government as lessor a royalty of "16$^{2}/_{3}$ percent in amount or value of production saved, removed or sold from the leased area." *Id.* at 1163 (footnote omitted). The Fifth Circuit held that royalties are due on take-or-pay payments only when those payments are recoupable and make-up gas is taken. *Id.* at 1168. The holding in *Diamond Shamrock* was based on the Court's conclusion that the royalty clause and the applicable federal regulations required a direct link between royalties and the production of gas (i.e. physical severance of the gas from the ground). The Court reasoned that, if a take-or-pay payment is nonrecoupable or if make-up gas to which the payment is credited is not taken, the requisite link between the take-or-pay payment and production of gas is not present, and no royalty may be assessed on the take-or-pay payment. *Id.* at 1168. This is because "[f]ar from being payments for the purchase of gas, take-or-pay payments are payment for the pipeline-purchaser's failure to purchase (take) gas," which failure is not directly associated with production *Id.* at 1167 (footnote omitted). The Court also based its holding on the observation that "[t]ake-or-pay payments are intended to compensate primarily the producer, not the owner of the minerals, for the risks associated with development production." *Id.* In addition, the Court noted that assessing royalties on take-or-pay payments would present formidable accounting problems that should be avoided. *Id.* at 1166.

In *Frey v. Amoco Production Co.*, 943 F.2d 578 (5th Cir. 1991), *withdrawn in part*, 951 F.2d 67 (5th Cir.), *original opinion reinstated in part*, 976 F.2d 242 (5th Cir. 1992), the

Fifth Circuit revisited the take-or-pay issue and held that a private (i.e., non-federal, non-Indian) lessor was entitled to royalties on a settlement payment relieving take-or-pay liability under a long-term gas-purchase contract. The Fifth Circuit panel in *Frey* distinguished *Diamond Shamrock* on the ground that the royalty clause in the lease construed in *Diamond Shamrock* was different from the royalty clause in the lease at issue in *Frey*. In *Frey*, the royalty on gas sold by the lessee was set at "one-fifth (1/5) of the amount realized at the well from. . . sales" of gas. *Id.* at 582 n.2. In addition, the panel in *Frey* was applying the state law of Louisiana, not federal law, to the interpretation of the lease. *Id.* at 581. Nonetheless, the panel in *Frey* distanced itself from certain central tenets of the *Diamond Shamrock* analysis, and applied an analysis and reached a result vastly different from those in *Diamond Shamrock*. The *Frey* panel rejected the argument that accounting difficulties that may arise from assessing royalties on take-or-pay payments can constitute a reason for holding that take-or-pay payments are not royalty bearing. The *Frey* panel stated: "we know of no authority for the proposition that accounting complications should abrogate legal rights." *Id.* at 583 n.4. The panel in *Frey* adopted an economic analysis of the take-or-pay payments that differs dramatically from the *Diamond Shamrock* analysis. The *Frey* panel's economic analysis is excerpted as follows:

> The [take-or-pay] payments, like the market price paid for gas taken, constitute economic benefits that [the lessor] received from granting [the lessee] the right to take gas from the leased premises, a right that [lessee] got through the Lease. It would be contrary to the nature of the

> lease as a cooperative venture to allow a benefit by any name that is attributable to the gas under the leased premises to inure exclusively to the lessee.
>
> . . . .
>
> If lessors did not share in take-or-pay payments, lessees would have an incentive to compromise volume gas prices under their contracts or settlements with pipelines in exchange for favorable take-or-pay terms.

Id. at 584-85 (footnotes omitted). This analysis recognizes that take-or-pay payments are consideration the lessee enjoys that is derived from the right the lessor has granted to the lessee to extract gas from the lessor's land. The take-or-pay payment is an economic benefit directly derived from this grant of rights from the lessor to the lessee, and "[i]t would be contrary to the nature of the lease" to allow this benefit to inure solely to the lessee. This analysis contradicts the *Diamond Shamrock* analysis that take-or-pay payments, as "payment for the pipeline-purchaser's failure to purchase gas," are not linked closely enough with production to be royalty bearing unless associated with gas actually produced. *Diamond Shamrock*, 853 F.2d at 1167. The *Frey* panel explicitly acknowledged that its characterization of the nature of take-or-pay payments might "contradict *Diamond Shamrock's* assertion that 'take-or-pay payments are payment for the pipeline-purchaser's failure to purchase . . . gas.' " *Frey*, 943 F.2d at 584 n.5 (quoting *Diamond Shamrock*, 853 F.2d at 1167).

The Eighth Circuit in *Klein v. Jones*, 980 F.2d 521 (8th Cir. 1992), held that a class of approximately 3000 non-

federal, non-Indian lessors, who brought an action against the lessee/producer seeking a portion of moneys paid by a pipeline company in a settlement relieving take-or-pay liabilities and effectuating a contract buydown, were entitled to relief both on a theory of unjust enrichment and on breach of an implied covenant to market gas. *Id.* at 533. The royalty clause in the lease at issue in *Klein* included "amount realized from [the sale of gas]" language similar to that in the lease before the court in *Frey*. The Eighth Circuit employed an economic analysis similar to that employed by the Fifth Circuit panel in *Frey*, and held that the settlement was royalty bearing. Aware that the settlement payment constituted an economic benefit to the lessee that directly originated in the lease arrangement between the lessee and the lessor, the Court stated that " 'it would be contrary to the nature of the lease as a cooperative venture to allow a benefit, *by any name*, that is attributable to the gas under the leased premises to inure exclusively to the lessee.' " *Klein*, at 530 (quoting *Frey*, 943 F.2d at 584; emphasis added). The Court also added that to permit " 'either the lessor or the lessee to receive a part of the gross revenues from the property greater than the fractional division contemplated by the lease, should be considered inherently contrary to the basic nature of the lease. . . . ' " *Id.* at 531 (quoting *Henry v. Ballard & Cordell Corp.*, 418 So.2d 1334, 1338 n.10 (La. 1982)); *see also id.* at 533 (Bright, J., concurring) ("[The lessees] may have reaped a substantial benefit from the lease that purported to be unrelated to the production of gas. This result would conflict with the underlying purpose of the lease, which is for the lessor to receive a share of all proceeds generated by the land, and

may have resulted in [the lessees] receiving a potentially unjust enrichment.").[3]

Independent Petroleum Association of America v. Babbitt, 92 F.3d 1248 (D.C. Cir. 1996) (*"IPAA"*), involved the situation where (a) a pipeline company paid Samedan Oil Corporation (a producer/lessee on Indian lands) a lump sum nonrecoupable settlement payment to extinguish its liabilities under a take-or-pay contract and (b) Samedan simultaneously entered into a substitute contract with a new purchaser for the gas that was freed up by the settlement. *Id.* at 1254. The royalty clause in *IPAA* was similar to the royalty clause in *Diamond Shamrock*. Relying on *Diamond Shamrock*, the District of Columbia Circuit held that nonrecoupable settlement payments were not royalty bearing, because in the absence of recoupment (i.e. the taking of make-up gas), there was not a sufficient nexus between the settlement payment and actual production of gas. *Id.* at 1259-60. The dominant consideration in *IPAA* was whether the settlement payment was recoupable. *Id.* at 1259 ("a nonrecoupable settlement payment is *never* credited as payment for any gas actually severed from the ground.") (emphasis added).

Finally, in the case at bar, the Sixth Circuit upheld MMS's royalty assessment on a nonrecoupable settlement

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[3] The Eighth Circuit subsequently reaffirmed the position it had taken in the original *Klein* decision. *See Klein v. Arkoma Prod. Co.*, 73 F.3d 779, 786 (8th Cir.) (holding lessee violated implied covenant to market when it did not pay royalty owners a proportionate share of settlement payment relieving take-or-pay liability; also holding for lessor on unjust enrichment grounds), *cert. denied*, 117 S. Ct. 65 (1996).

payment made to extinguish a contract imposing take-or-pay liability. *In re Century Offshore Management Corp.*, 111 F.3d 443 (6th Cir. 1997), Century Offshore Management Corporation ("Century") was the lessee of federally-owned submerged lands in the Gulf of Mexico. *Id.* at 445. Century sold gas to Enron Gas and Marketing, Inc. ("Enron") under a take-or-pay contract. *Id.* Enron paid Century a $12,250,000 lump-sum payment to terminate that contract and replace it with a new contract – between the same two parties – based on the current, floating market price for gas. *Id.* The lease in *Century* included a royalty clause turning on "amount or value of the production saved, removed, or sold by the lessee," which is similar to the royalty clauses in the leases at issue in *Diamond Shamrock* and *IPAA*, and which did not expressly refer to the "amount realized from the sale of gas" as did the royalty clauses in *Frey* and *Klein*. The Sixth Circuit upheld MMS's assessment of royalty on the take-or-pay settlement payment when gas was actually produced under the substitute contract, because it viewed the settlement of the take-or-pay contract and the substitute contract to be interrelated transactions, and viewed the initial settlement as an advance payment for the gas eventually produced under the substitute contract. *Century*, 111 F.3d at 448-49. The Court cited to the definition of "gross proceeds" in the regulations pertaining to federal leases, which are defined as " 'the total monies and other consideration accruing to an oil and gas lessee for the disposition of oil or gas produced.' " *Id.* at 446 (quoting 30 C.F.R. § 206.151 (1996)).

The Sixth Circuit focussed on the fact that the parties to the settled contract and the parties to the substitute

contract were the same, and thus viewed the settlement payment as a prepayment for gas produced in the future. By contrast, in *IPAA* the District of Columbia Circuit's application of the *Diamond Shamrock* analysis to the settlement payment context centered on whether the settlement payment was recoupable. *See IPAA*, 92 F.3d at 1259. The *Century* and *IPAA* cases involved leases with virtually identical royalty provisions, and thus cannot be distinguished on that basis.

C. Analysis of the Divergence Among the Circuits on this Issue

There is a broad divergence among the Circuits over whether royalties may be assessed on take-or-pay payments and settlement payments intended to relieve take-or-pay liability. To a substantial degree, this divergence results from different understandings of the economic functions of the take-or-pay obligations. The Fifth Circuit in *Frey* and the Eighth Circuit in *Klein* looked at the relationship among the lessor, lessee and pipeline company and concluded that the lessee's right to enjoy take-or-pay payments is derived from the rights the lessor granted to the lessee, and that the nature of the lease relationship required the lessee to share those payments with the lessor through the royalty clause. By contrast, the Fifth Circuit panel in *Diamond Shamrock* viewed take-or-pay payments merely as payments intended to compensate the lessee/producer for the purchaser's failure to take gas and for the risks associated with production that the lessee, not the lessor, bears. The Fifth Circuit in *Diamond Shamrock* therefore concluded that those payments

are not royalty bearing unless and until make-up gas is taken. *IPAA* followed the *Diamond Shamrock* analysis and directed its attention to whether the settlement payment was recoupable. The Sixth Circuit in *Century* diverged from *IPAA*, focused on the fact that the parties to the settled and substitute contract were the same, and viewed the settlement payment as a *de facto* prepayment for gas produced under the substitute contract. These divergent approaches to the same issue have generated inconsistent results and substantial uncertainty as to whether a specific take-or-pay settlement payment will be royalty bearing under a specific royalty clause.

The differences in the language of the respective royalty clauses cannot explain the fundamentally different approaches to this issue adopted by the various Circuits. It is true that royalty clauses in *Klein* and *Frey* based royalty on the "amount realized from [the sale of gas]," while the royalty clause in *Diamond Shamrock* based royalty on the "amount or value of production saved, removed or sold from the leased area." However, *IPAA* and *Century* both involved royalty clauses of the *Diamond Shamrock* variety, yet reached different results from one another. Moreover, the federal regulations governing federal and Indian leases eliminate any purported distinction between a "value of production" royalty and an "amount realized" royalty in this context. The regulations governing royalty in Indian leases base royalty on the value of minerals produced, but also use the amount realized from the sale of the minerals in determining that value. *See* 25 C.F.R. § 211.13(a) (1996) ("The lessee shall pay . . . a royalty of 12½ percent of the value or amount of all oil, gas and/or natural gasoline, and/or other

hydrocarbon substances produced and saved from the land leased. . . . The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary of the Interior, be deemed mere evidence of or conclusive evidence of such value.").[4]

Likewise the applicable federal valuation regulations unambiguously set forth that the value of gas includes "the total consideration actually transferred either directly or indirectly from the buyer to the seller for the gas." 30 C.F.R. § 206.152(b)(1)(ii) (1996):

> In conducting reviews and audits, MMS will examine whether the contract reflects the total consideration actually transferred either directly or indirectly from the buyer to the seller for the gas. If the contract does not reflect the total consideration, then the MMS may require that the gas sold pursuant to that contract be valued [under a constructive arms-length contract]. Value may not be less than the gross proceeds accruing to the lessee, including the additional consideration.

See also id. § 206.152(b)(3) ("MMS may require a lessee to certify that its arm's-length contract provisions include all of the consideration to be paid by the buyer, either directly or indirectly, for the gas."). These regulations are intended in part to prevent self-serving contracts between

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[4] This language has been incorporated directly into leases issued by the Secretary of the Interior on Indian lands. *See* Bureau of Indian Affairs Lease Form 5-137, § 3(c) ("The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary, be deemed mere evidence of or conclusive evidence of such value.").

lessees and purchasers of production that deprive the lessor of a royalty on a benefit the lessee has derived from the lessor's land. These federal regulations demonstrate the futility of trying to reconcile the decisions of the Circuit Courts by reference to the different royalty clauses. Under those regulations the "amount realized" by the producer is simply one way of determining the "value of production" for purposes of royalty. Accordingly, the Tribe submits that the real issue underlying the varied outcomes of these cases is whether the economic analysis employed by *Klein* and *Frey*, or the economic analysis employed by *Diamond Shamrock*, to evaluate take-or-pay settlement payments is correct. The Tribe further submits that the *Klein/Frey* analysis comports with the Secretary of the Interior's trust obligations to maximize royalties on Indian lands, while the *Diamond Shamrock* analysis does not.

As discussed above in Section I, the language setting forth the basis on which royalties are assessed on federal leases is similar to the language defining the royalties on Indian leases. The Tribe respectfully suggests that this Court grant the petition for a writ of certiorari in order to set forth which of the conflicting analyses among the circuits discussed above is correct. Such clarification would provide guidance to the Secretary in assessing royalties on lump-sum settlement payments between producers and pipeline companies extinguishing take-or-pay liability on the Jicarilla Apache Reservation.

CONCLUSION

For the foregoing reasons, the Jicarilla Apache Tribe respectfully suggests that this Court grant Century Offshore Management Corporations's petition for a writ of certiorari.

Respectfully submitted,

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